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PHILIP MORRIS

Although A Little Confusing At First Glance, 1988 Results Reached Aggressive Targets; Purchase Recommended

Investment Opinion: BUY — Recommended List

1/26/89 Price (MO/NYSE)	52-Week Range	Earnings per Share 1987	Earnings per Share 1988A	Earnings per Share 1989E	P/E Ratios 1988A	P/E Ratios 1989E	Ind. Div.	Current Yield	Normalized 5-Yr. Est. EPS Growth Rate
$108	$110-81	$7.75	$10.03	$11.55	10.8	9.4	$4.50	4.2%	20%
	Previous Estimate:		$10.00	—					
	1989 Est. ROE:	33%		Debt as % of Capital (9/30):			36%		

Investment Opinion

As a result of the acquisition of Kraft, Philip Morris has become one of the world's most powerful consumer products companies and offers investors the opportunity for above-average earnings, cash flow and dividend growth. We expect that the dilution from the Kraft acquisition will be eliminated late in 1991 and that Kraft will add modestly to Philip Morris' profits in 1992. Furthermore, the company's earnings mix continues to change, with food and beverage representing an increasingly larger percentage of the total operating profit mix. In 1989 they will equal an estimated 32% of operating profits, versus our original forecast of 20%. Therefore, we believe Philip Morris' price/earnings multiple will shift upward to reflect the higher valuations accorded those businesses. In addition, we expect the market to place a higher valuation on Philip Morris' earnings based on the premium multiple paid for RJR Nabisco, because litigation concerns continue to subside, and because of the company's accelerating market share gains in key worldwide product categories. Thus, purchase of the shares is recommended for capital appreciation.

1988 Results On Target

Although a little confusing at first glance, because of nonrecurring charges and credits, Philip Morris' results in 1988, either in the aggregate or by division, reached or exceeded our expectations. Revenues in 1988 advanced 13% to $31.7 billion, up from $28.2 billion in 1987. Sales last year included $821 million of revenues from the Kraft Corporation, which was included in Philip Morris' results only as of December 7, 1988. Excluding the Kraft contribution, revenues just from ongoing operations rose almost 10% to $30.9 billion. Earnings per share rose 29% to $10.03, up from $7.75 in 1987. (Our estimate was $10.00 per share.) We would add that in 1988 Philip Morris adopted Financial Accounting Standards No. 96, Accounting for Income Taxes, which resulted in an increase in net income of $213 million, or $0.91 per share. We would also note that prior 1988 quarters were restated to give retroactive effect to this change. As a result, earnings per share in the first quarter of 1988

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were increased by $1.12 and the second, third, and fourth quarters were reduced by $0.07, $0.08, and $0.06, respectively.

We would also note that the one-time gain from the adoption of the new accounting standard was exactly offset in the fourth quarter by a restructuring charge at General Foods USA and General Foods Worldwide Coffee and International. The charges related to a plant closing, consolidation of manufacturing facilities, early retirement programs and other overhead cost reductions. We estimate that the restructuring will result in improved cost efficiencies of around $100 million. We would expect these savings to impact reported results commencing in 1990, as the restructuring will be gradually implemented throughout 1989.

Philip Morris' fourth-quarter results were impacted by these events and require some special explanation. First, the company reported that net earnings per share declined by 27% to $1.48 per share, down from $2.02 a year earlier. We would note that earnings were negatively impacted by the $0.91 per share restructuring charge at General Foods and by $0.06 per share associated with the adoption of FASB #96. Excluding these two items reveals that earnings per share just from operations were $2.45 per share, which was almost exactly in line with our estimate of $2.44 per share. Unit shipments in key business sectors expanded in the fourth quarter as follows: Domestic cigarettes, 1.5%; International cigarettes, 2.0%; and Beer 3.5%.

Domestic Cigarettes. Philip Morris' domestic cigarette revenues in 1988 rose 11% to $8.5 billion, while operating profits benefited from aggressive pricing, and very modest variable cost increases advanced almost 14% to $3.1 billion. Unit sales rose 1.7% to 219.3 billion sticks, up from 215.6 billion in 1987, and Philip Morris' share of market increased to approximately 39.3% from 37.8%. The Marlboro brand franchise continued an incredibly strong performance, with shipments rising 3.1% to 138.8 billion units, up from 134.6 billion in 1987. Brand volume was boosted by Marlboro Lights and the introduction of Marlboro Menthol.

International Cigarettes. The star performer in Philip Morris' portfolio of tobacco companies continues to be the firm's international cigarette business. Revenues in 1988 advanced 15% to $8.1 billion, margins expanded to 9.6% from 8.3%, and operating profits climbed 33% to $774 million. International unit shipments rose 4.4% to 334.7 billion sticks. Sales were boosted significantly by export volume, which advanced 13.2% to 68.8 billion units. On a worldwide basis, including domestic shipments, Philip Morris' total cigarette volume rose 4.4% to 554 billion units.

General Foods. General Foods' worldwide revenues rose 5% to $10.4 billion, while operating profits were flat at $771 million before nonrecurring operating charges in both 1987 and 1988. Analyzing General Foods' operations by sector reveals that General Foods U.S.A. experienced a 7.8% increase in unit volume, a 10% rise in operating revenues to $3.8 billion, and a 14% jump in operating profits, before restructuring costs, to $438 million. Contributing to this performance were strong results by Bird's Eye, Jell-O, and Kool-Aid.

The worldwide coffee and international business experienced a slight revenue gain to $4.4 billion. However, operating income excluding restructuring costs fell 34% to $165 million. Maxwell House continues to have unsatisfactory results. We estimate that the operating losses in domestic coffee equaled or exceeded $50 million. The major problem was an attempt to recover market share loss experienced earlier in the year, and the marketing expenditures associated with this share reversal severely impacted profits. By contrast, the company experienced a strong performance in the interna-

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tional coffee sector, where volume advanced 6% with the strongest gains recorded in Europe and Asia.

Tonnage growth at Oscar Mayer Foods continued to be excellent with sliced luncheon red meat volume rising 7.6%, while tonnage of Louis Rich turkey products expanded 13.7%. Oscar Mayer's total operating revenues increased 5% to $2.3 billion, and operating income rose over 15% to $197 million.

The results of Kraft, Inc. were included only since December 7, 1988. On this basis Kraft contributed $821 million to operating revenues and $78 million to operating income. Tonnage growth for all of Kraft's divisions in the fourth quarter rose by 4%. On a full year basis, tonnage of U.S. consumer foods and international operations each rose 4%, while volume in the U.S. commercial foods sector expanded almost 19%.

Miller Brewing registered one of its strongest sales gains in many years, with a 3.5% unit volume increase to 40.7 million barrels. While operating revenues rose 5% to $3.3 billion, margins widened to 5.8% from 5.5% and operating income climbed 12% to $190 million. The performance of Miller continued to be led by Genuine Draft, the sales of which expanded over 50% for the second consecutive year.

Philip Morris' financial service and real estate units registered a 29% increase in operating revenues to $629 million, and operating income rose 85% to $163 million, up from $88 million in the year-earlier period. The profit advance was aided by an aggressive land sales program in the real estate operations in California. We would note that the acquisition of Kraft did dilute fourth-quarter earnings by $0.12 per share, and that the full-year tax rate was unusually low at 37.3% reflecting the adoption of FASB No. 96. Importantly, our earnings estimate for 1989 remains unchanged at $11.55 per share. Other details of Philip Morris' year-end results are outlined in Table 1.

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Listed options on this issue are available.

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TABLE 1

PHILIP MORRIS COMPANIES INC.

OPERATING ANALYSIS BY LINES OF BUSINESS

(Dollar Amounts in Millions)

	1987R	1988	Percent Change
Operating Revenues by Business			
Philip Morris U.S.A.	$7,640	$8,501	11%
Philip Morris International	7,004	8,085	15
General Foods Corporation	9,946	10,444	5
Kraft	----	821	
Miller Brewing	3,105	3,262	5
Financial Services, Real Estate & Other	488	629	29
Total Operating Revenues	$28,183	$31,742	13
Operating Profits by Business			
Philip Morris U.S.A.	$2,715	$3,087	14
Operating Margin	35.5%	36.3%	
Philip Morris International	$582	$774	33
Operating Margin	8.3%	9.6%	
General Foods Corporation	$773	$771	-0
Operating Margin	7.8%	7.4%	
Kraft	---	$78	
Operating Margin	---	9.5%	
Miller Brewing	$170	$190	12
Operating Margin	5.5%	5.8%	
Financial Services, Real Estate & Other	$88	$163	85
Operating Margin	18.0%	25.9%	
Total Operating Income	$4,328	$5,063	17
Operating Margin	15.4%	16.0%	
Amortization of Goodwill	$105	$125	19
Restructuring of General Foods Corporation	71 (1)	348	390
Unallocated Corporate Expenses	162	193	19
Interest Expense, Net	646	670	4
Pretax Income	$3,344	$3,727	11
Taxes	1,502	1,390	-7
Tax Rate	44.9%	37.3%	
Net Income	$1,842	$2,337	27
Earnings Per Share	$7.75	$10.03	29
Average Shares Outstanding	237.8	233.0	-2

(1) Includes a $117 million restructuring charge and a $46 million gain from the sale of Open Pit barbeque sauce.

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